10. Because INA and Multimedia Conferencing were related, we did not separate time charges for a short period. Multimedia Conferencing was a small project which was abandoned after little work was done. We do not regard this as a major problem with our tracking procedures; the auditors are using hindsight to say we should have tracked separately, but this was not clear to us then.

11. The Gigabit Data Service trial is still in progress (an extension to September 1994 was granted). We explained customer benefits in our technology test filing (see RD-008); a cost/benefit analysis was not possible. We will know more after the trial is completed.

V. ENHANCED SERVICES

A. Our CVM Trial Followed Applicable Rules.

Contrary to the Draft's statement (page B-56), our trials of coin voice messaging (CVM) are still continuing. The description of CVM options is taken from a preliminary assessment, written before any trials were conducted. We selected Option 2, which involved taking existing intelligent public phone sets and upgrading them to intercept messages at modest cost. All options required an Enhanced Service Provider (ESP) because messaging is an enhanced service.

Contrary to the Draft's statements, we tried to involve other vendors in the trial besides ISG. We sent an information and invitation package to all ESPs in California advising of the trial and inviting participation. Each location which we chose could select any ESP and contract with it; we would then provide the intercept function in our sets under the same terms and conditions as ISG. Several hundred notices to ESPs were sent out, fewer than six companies responded, and none elected to participate.

Prior to any consideration of CVM, a business case to deploy 20,000 intelligent phones to improve maintenance and operational efficiencies had been approved. After we chose the locations and began deployment, we learned that the vendor for the intelligent sets had developed a call intercept for a CVM upgrade for another customer. Our vendor offered to upgrade our intelligent phones also, for an additional fee.

We investigated CVM options, decided that the upgrade option made the most sense, and then selected ISG (after contacting other ESPs). We gave ISG our specifications and required it to develop its messaging system at its own expense to meet them. We receive $.50 per message, plus additional network revenues earned as messages are delivered. These revenues are offset by the expenses of providing CVM: one expense is the cost of the messaging service provided by PBIS (successor to ISG) under the tariff. Bell and its payphone ratepayers, not ISG/PBIS, are the major benefactors of CVM.

The CPUC trial guidelines and our trial application allow us to use up to 5% of our public payphones. Since we have more than 148,000 public phones and have retrofitted fewer than 7,500, we are within this limit. The Draft's claim that we could only retrofit 5% of the 20,000 intelligent phones is false.

As in the case of PCS, the Draft criticizes us for following CPUC rules. These rules do not allow outside intervention during a trial, and permit us to offer the service at trial locations pending tariff approval. If we find that customers like and use CVM, we will seek prompt tariff approval so that they can continue using CVM in locations where they have found it useful. Our approach is appropriate and does not violate affiliate transaction rules.

B. Discontinued Or Recently Completed Enhanced Services Projects[22]

1. VALUE 2000 Was A Limited Experiment, Not A "Service".

We did not offer VALUE 2000 (V2000) "as a fully competitive service" (Page B-13, item 25) The V2000 platform was for a limited qualitative experiment only and was never intended as deployment grade. Our only modification of the PSTN was placing one adjunct platform beside one switch. In the V2000 experiment, a small number of households (only 30) could "play with" different concepts. After the households gave feedback on the services, they were modified based on the feedback and put back into the household for further study. Before the experiment, we notified the CPUC and gave a demonstration. We expected V2000 to identify new non-competitive services, such as new services to be tariffed, enhancements to existing tariffed services, and new applications of existing services, as well as new competitive services. V2000 was discontinued in January, 1992 after one experiment.. V2000 was not a market trial or technology test, but basic research to identify customer needs and desire for services in the year 2000. Formal ratepayer benefit analysis would not have been appropriate prior to V2000, but we did expect it to provide many customer benefits by enabling us to understand customer needs.

V2000 was not a vehicle for deploying any kind of service, let alone an enhanced service or any other competitive service. Currently we are working on two projects that could remotely be attributed to V2000. One, Do Not Disturb, has the same name and similar applications as a concept tested in V2000, but is functionally quite different from the V2000 concept. Do Not Disturb, if tariffed, will not be an enhanced service. The other project loosely linked to V2000 is an enhancement to an existing

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[22]See page 20, item 5, for Project ACORN (PERT) and Message Delivery Service.

service, Call Waiting, to enable Call Waiting to work with Delayed Call Forwarding. At the Call Waiting signal, the customer could choose to answer the call or have it forwarded elsewhere. Voice Mail providers would like this improvement to Call Waiting, but the enhancement would not be a new product.

C. Appendices C and D Are Full Of Inaccuracies.

There are many inaccuracies in the description of BISDN in Appendix C. It is not true that the activities described are all "competitive". There are also several inaccuracies in the description of ATM Technology in Appendix D. Many have been noted above.

The following projects listed in Table 2 under New Product Developments did not investigate new products and should not be categorized:

Video Communications Services--A joint marketing program with CLI.

Project Metrocore--A research project which did not look at any new products.

Gigabit Data Services--A technology trial, not product research.

INA Field Experiment Project--A platform architecture project, not product research..

BAGNet--Has not been categorized as competitive.

VI. ELECTRONIC YELLOW PAGES

Our response addresses the Draft's Findings and Conclusions (F&C), pp. 8-10 of Part C.[23] Space does not permit us to list and correct all errors in Part C. Throughout Part C, the auditors take hypotheses, visions, and strategies and present them as fact. Many statements are not supported by any data, and information in Pacific Bell Directory (PBD) documents is consistently mischaracterized. Finally, the auditors' desire to expose the ratepayer to the risks ofthe competitive electronic publishing business is completely at odds with their desire to put infrastructure improvement BTL.

A. F&C # 1: PBD's Contribution Is Irrelevant Under NRF.

The PBD contribution per residence access line per month from 1989 to 1993 ranged between $3 and $5. On January 1, 1990, at the startup of NRF, Bell rates were adjusted to earn the authorized rate-of-return, based on 1989 results. This startup adjustment effectively froze the 1989 PBD contribution per line into basic rates. Although the contribution has varied since 1989, under NRF these changes do not cause rates to change; rate changes can only occur with changes in the price cap index,

[23]See also pp. 83-85.

absent sharing.[24] Thus, ratepayers are now indifferent to changes in PBD's contribution; these changes benefit or harm shareholders, not ratepayers, depending on whether the contribution exceeded or fell below the 1989 level. This is the essence of NRF: Ratepayers are protected from the effects of Bell's actions, while shareholders bear the risks..

B. F&C # 2: Ratepayers Did Not Fund PBD's R&D.

Under NRF, ratepayers did not "fund" PBD's research and development. We have tracked all expenses associated with electronic publishing pursuant to the 1992 R&D Decision.[25] These expenses were reported in Attachment A of our Application for Electronic Publishing Service. $1.5 million was spent from July 1990 to December 1992.

These expenses were accounted for ATL in compliance with NRF, which requires ATL treatment prior to categorization (see discussion above, p. 4, p. 6). In 1993, electronic publishing was moved to PBIS. Since 1993, all electronic publishing expenses have been accounted for BTL. There is no basis for ratepayer compensation.

C. F&C # 3: No R&D Funds Were Spent Until 1990.

No funds were spent on electronic publishing work until the third quarter, 1990. From 1990 to 1992, $1.5 million was spent by the Electronic Yellow Pages (EYP) task force and these expenses were accounted for ATL, as required by NRF. The auditors refer to pre-1990 documents which show only PBD's generic interest in offering new products to advertisers.

The only new business development projects PBD undertook pre-1990 were three SMART trials (SMART Desktop, SMART Talk and SMART Post). These services were not the beginning of a long-term strategy for PBD to position itself for EYP. In fact, these services were completely unrelated to electronic publishing or EYP.

D. F&C # 4: Mr. Logan And Mr. Gaulding's Work Is Mischaracterized.

PBD hired Mr. Logan as a new business development manager. His mission was to investigate the feasibility of PBD's entry into new lines of business. EYP and electronic publishing were two areas he investigated. PBD believed then that it was a candidate to offer these services. However, it later determined that these services should be offered elsewhere, for several reasons (discussed below).

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[24] As shown above, p. 3, from 1990 through 1993, we did not come close to sharing.

[25] The appropriate treatment of these expenses is an issue in our Application for Electronic Publishing Service.

While Mr. Gaulding was PBD's President, there was no major funding for either EYP or electronic publishing.[26] The visionary strategy and direction for electronic publishing that the auditors attribute to Mr. Gaulding consisted of a few statements and reports. Mr. Gaulding's primary responsibilities were to reinvigorate the core business and explore marketing services opportunities. Since Mr. Gaulding left in 1990, we have decided that PBD is not the appropriate place for any electronic publishing services we may offer.

E. F&C # 5: Amounts Spent On Electronic Publishing Were Not Substantial.

"Substantial" PBD resources were not involved in electronic publishing. The EYP task force was not formed until second quarter, 1990; cumulative expenses associated with its activities were approximately $1.5 million from July 1990 through December 1992.

F. F&C # 6: Only Limited Studies Were Conducted.

Limited feasibility studies were conducted from 1990 to the end of 1992. These studies primarily focused on marketing issues, not capabilities analyses. We studied how consumers and businesses use information to make purchasing decisions. At most, they contained pro-forma income statements, unsupported by any market acceptance research.

G. F&C # 7: Electronic Publishing Involves High Risk.

The studies generally show that electronic publishing and EYP are highly competitive and risky services. Even if offering EYP and electronic publishing services would be a sound business decision for an RBOC, it does not follow that PBD is the appropriate place to offer these services, or that they should be treated ATL. Nor does it imply that an RBOC is guaranteed success. In fact, while two Bell Companies (New Jersey Bell and Bell of Pennsylvania) offer electronic publishing services, their accounting treatment is BTL.

H. F&C # 8: The Brooks-Dingell Bill Prohibits Use Of Any PBD Synergies.

Even if there are synergies between Bell and EYP, this does not mean that PBD is the appropriate place for these services. The auditors ignore the pending legislation (H.R. 3626,

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[26]There was no major funding of these services because the Modification of Final Judgment prohibited Directory's entry into this line of business. United States v. AT&T, 552 F.Supp. 131 (D.D.C. 1982).

the Brooks-Dingell Bill), which would prohibit an RBOC from using the very items that the auditors list as providing a competitive advantage for electronic publishing services.

I. F&C # 9: Electronic Publishing Is Not A Major Threat To PBD.

We have not seen any factual data to substantiate the auditors' claims that electronic publishing will offer serious competition to traditional Yellow Pages in the foreseeable future. The Yellow Pages industry continues to be strong. While we cannot be sure about the future impact of alternative advertising media, we can make educated guesses using an historical analysis of competing advertising media. Directory advertising has been among the three fastest growing media since 1975.

GROWTH IN ADVERTISING MEDIUM[27]

Compound Annual Growth Rules

	1975-1980	1980-1985	1985-1990	1991
Newspapers	12.4%	11.2%	5.5%	(5.3)
Magazines	16.5	10.4	6.0	(4.0)
TV	16.6	12.0	6.1	(3.1)
Cable TV	n/a	67.6	16.9	(11.0)
Radio	13.3	11.9	6.2	(3.2)
Direct Mail	13.0	15.3	8.8	4.0
Yellow Pages	**17.7**	**13.5**	**8.3**	**4.3**

Although the industry experienced modest declines during the recent recession, Link Magazine, April 1994, reports that Robert Coen, an advertising expert with McCann-Erickson, expects advertising revenues for directories to increase 4% in 1994. This exceeds the Yellow Pages Publishers Association forecast of 3.5% growth for 1994. Industry forecasts call for continued modest growth through the decade.

[27] Sources: 1975-1990 data: "Newspapers v. Yellow Pages, 1991-92: The Competitive Outlook", by Robert Abramson, Communications Trends, Inc., ©1991; 1991 data: "Yellow Page Market Forecast, 1992" by Carl Mercurio, Communications Trends, Inc., ©1992.

J. F&C #10: We Followed Applicable Rules When Electronic Publishing Was Moved.

PBD did not "abruptly" cancel research and development activities in 1992[28]. When PBD began work on electronic services, it assumed that there was a business opportunity for PBD in this area. Subsequent work showed the risky, speculative nature of this business and the lack of critical synergies with PBD's core business.

PBD did transfer some personnel involved in electronic publishing to PBIS. We complied with the affiliate transaction rules applicable to this transfer (i.e., PBD was paid a fee equal to 25% of annual salary for each person) and we notified the CPUC.

K. F&C #11: The Brooks-Dingell Bill Led To A Further Move.

In April, 1994, electronic publishing was transferred to a Telesis subsidiary, largely because of the uncertainties created by H.R.3626. This bill would prohibit both PBD and PBIS from engaging in electronic publishing.

L. F&C #12: Electronic Publishing Lacks Synergies With PBD.

Pacific Telesis Group does not prohibit PBD from exploring R&D or enhancing its products.[29] As stated above, the Yellow Pages industry is strong and is expected to grow through the end of the decade. PBD will not offer electronic publishing services for the following reasons:.

- PBD's business system is optimized for print publishing, not electronic publishing, and the requirements of the two businesses are quite different.

- PBD's sales force is fully occupied in selling printed Yellow Pages ads. To divert this sales organization from its current, highly profitable business to a speculative new business would be a poor business decision.

- PBD's sales force is in most California markets for only a few weeks each year. Selling electronic publishing services will require a year-round market presence.

- PBD's Information Management System is a non-relational database system which is incapable of handling the demands of electronic publishing.

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[28] The auditors say electronic publishing was moved out of Directory in 1992, but the actual year was 1993.

[29] An example of Directory development is Front of the Book (FOB) audiotex. There is no tie between FOB audiotex and electronic publishing, as the auditors suggest.

- In short, the auditors assume (1) there are problems at PBD and (2) putting electronic publishing into PBD would solve the problems. Neither assumption is justified.

M. F&C #13: Ratepayers Are Protected By NRF From Revenue Losses.

The auditors' cannibalization theory finds harm to ratepayers if electronic publishing services are treated BTL. Their theory seems to be as follows: In NRF, there is a rate-of-return floor in case the price cap index mechanism fails to work. The cannibalization theory assumes that ATL PBD revenues could become so eroded by BTL electronic publishing services that Bell's results would drop below the floor. The theory then assumes that the CPUC would increase Bell rates to offset the erosion, and that the increases can be prevented by treating electronic publishing revenues ATL. If PBD revenues are eroded, revenues would simply move from one ATL service to another and therefore not reach the rate floor.

The cannibalization theory is completely invalid. First, Bell does not get an automatic rate increase when the rate-of-return falls below the floor. Bell cannot simply ask for a rate increase because of a low rate-of-return, as it might have in the days of general rate cases. Instead, after two years of earnings below the floor, Bell must petition for reconsideration of the price cap index and show that price caps have failed to work. But the CPUC would never modify the price cap index and Bell could show was erosion of PBD revenue by BTL electronic publishing.

Moreover, the theory is not supported by any evidence. No one has developed an electronic publishing application that poses a threat to PBD revenues. Finally, the theory ignores the size of PBD's contribution compared to Bell's earnings and the floor rate-of-return. For example, excluding December 1993, which included huge accounting adjustments for corporate restructuring, the total elimination of all PBD's contributions would not have caused Pacific's results to fall below the floor during any of the first four years of NRF (See page 3, above). Erosion of PBD revenues cannot by itself cause Bell's results to reach the floor.

N. F&C #14: PBD Will Focus On Reinvigorating Its Business.

See Response to Findings and Conclusion #9. The way for PBD to maintain and enhance its competitive position is to continually reinvigorate the printed Yellow Pages business. PBD is committed to this strategy and is exploring many product enhancements. Finally, the proliferation of competitive printed directories proves that independent third parties, as well as PBD, see significant opportunities for growth in the print directory business.

O. F&C #15: Our Change In Strategy Was Based On Many Factors.

Our change in strategy is attributable to the following:

1. Ratepayers did not fund any research and development for electronic publishing services.

2. Subsequent research at PBD showed the risky, competitive nature of the business and the lack of critical synergies with PBD's core business.

3. H.R. 3626 (Brooks-Dingell Bill) would prohibit either PBD or any other Bell company from engaging in any electronic publishing activity.

4. Other competitive electronic publishing services are not regulated.

5. Other Bell operating companies' electronic publishing services are in non-regulated affiliates and treated BTL.

6. We would be hampered in our ability to form joint ventures with others if we are regulated while our competitors are not regulated.

P. F&C #16: Our Accounting Procedures Are Adequate.

The auditors apparently misunderstood the project manager's statement to mean that $1.5 million dollars in expenses were incurred after the beginning of tracking in the fourth quarter of 1992. While PBD could not track expenses to the project level during this time period, it did track all expenses associated with the EYP task force from its inception in the 2nd quarter of 1990. The $1.5 million represents all the expenses associated with electronic publishing.

The auditors imply that expenses associated with the Information Management System project (IMS) should have been partially tracked with the EYP project. This is incorrect. IMS was built for the sole purpose of managing the printed Yellow Pages database and publishing infrastructure. IMS was not designed to support and cannot support electronic publishing.[30]

Q. F&C #17: Cross-Subsidization Did Not Occur.

The electronic publishing costs incurred by Bell and PBD were accounted for ATL in 1990, 1991, and 1992, as required by NRF. The shareable earnings threshold would not have been met had these expenses been recorded BTL. Since the exclusion of such expenses would not have produced shareable earnings for 1990-1992, ratepayers were not affected by treating these expenses ATL. From 1/1/93 forward, all RD&D expenses for electronic publishing services have been and will be recorded

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[30]Although EYP task force initially considered relational capability for IMS, this was abandoned.

BTL until the correct accounting treatment is determined in App. No.93-11-031 (Electronic Publishing Application).

We find the auditors' statements about cross-subsidization puzzling. They appear to believe that electronic publishing should be treated ATL to prevent cross-subsidization, but this makes no sense. The CPUC has stated that enhanced services should be treated BTL and excluded from the sharing mechanism in order to prevent cross-subsidies. (See D. 89-10-031, 33 Cal.P.U.C. 2d at 143). Finally, BTL accounting and NRF prevent any cross-subsidization.

R. F&C #18: Current Rules Protect Ratepayers.

Under NRF, ratepayers do not "fund" product development. The auditors cannot show that any electronic publishing R&D expenses were incurred prior to 1990 or that subsequent expenses affected any NRF calculations. In addition, the auditors do not identify any affiliate transaction rule that is inadequate. Finally, the auditors have not shown that ratepayers bore any risk as a result of the limited research done at PBD. In fact, most of the development and investment costs for electronic publishing have not yet been incurred.

S. F&C #19: The Draft Is An Advocacy Document, Not An "Audit".

The BTL treatment of electronic publishing is at issue in App. No. 93-11-031 (Electronic Publishing Application). We believe Part C of the Draft represents the auditors' views of how that issue should be resolved. Although Part C contains many allegations, they are unsubstantiated. Part C cannot be viewed as a neutral, fact-based audit.

REPLY COMMENTS TO PACIFIC TELESIS GROUP'S RESPONSE TO THE DRAFT AFFILIATE INTERESTS AUDIT REPORT

Introduction

As arranged during the preaudit phase of this project Pacific Telesis Group (PTG) was given an opportunity to review a draft of the report prior to its release for the purpose of (1) identifying proprietary information and (2) responding to the report with comments. Comments were prepared by PTG and are included in the previous section. This document is the audit team's replies to those comments.

Overall Comments

In reviewing PTG's comments, it is clear that PTG misunderstood or chose to ignore the scope of the audit. This was not merely a traditional compliance audit, as hoped for by PTG. The goal of this audit was to satisfy the concerns expressed in the NARUC resolution. Page A-3 of the report states in plain language the questions and issues that are raised by the resolution, such as cross-subsidies, cost shifting, resource draining, etc., and the effort by the audit team was to answer those questions. The question is simply whether these inappropriate practices exist or not, and to what extent, regardless of the regulatory framework or rules that may be in place.

The central theme of PTG's response appears to focus on their claim of diligent compliance with regulatory rules, especially in light of the new regulatory framework that is now in place in California. It would seem from PTG's response that all should be all right as long as the sharable earnings threshold is not breached. Under present earnings (1993), it would take about one billion dollars for Pacific Bell to reach that threshold. PTG's theory would have the regulators believe that if a billion dollar expenditure, funded from rates, was used to cross-subsidize a competitive venture, the regulators should not be concerned, as long as the shareable threshold is not impacted. In this case, one billion dollars is the potential subsidy effect.

No new regulatory frameworks or regulated environments should be used as a shield to cover all of a utility's irregularities. The audit team approached this review with the tenet that cross-subsidies, improprieties, etc., as envisioned in the NARUC resolution, are wrong as a matter of public policy and should be identified where they exist.

On the other hand, all legislative bodies, federal and state, Judge Greene's court, and regulatory agencies, both federal and state, that have jurisdictions over the RBOCs, are concerned with potential cross-subsidization and anti-competitive behavior as the telecommunications industry enters into a more competitive environment. The audit team is not aware of any regulatory agencies' price cap regulations that say the RBOCs may do as they please in cross-subsidizing their competitive lines of business up to the shareable threshold. PTG cited the Brooks-Dingell bill a number of times in their response to the audit report. It should be noted that the drafters of that bill were especially concerned with the issues of cross-subsidization and anti-competitive behavior. The same concerns were also expressed in the Hollings bill.

PTG implies that the audit team is against new technology. It is not. The audit team supports progress and enhancements to the telecommunications infrastructure and sees technological advancement in the telecommunications industry as in the public interest. However, as long as there is a distinction between who benefits and who does not from such advancements, then care must be exercised in determining who pays for the development of these advancements. The team's findings regarding the inadequacies in the cost tracking system to fully reflect the appropriate costs by project is consistent with NARUC's expressed concern in this area.

PTG's responses often criticize the team's report for mischaracterizing hypotheses, visions, and strategies as fact. It should be noted that many of the items reported were included to depict the process and company actions that were unfolding during the many years of development (e.g. EYP and PCS), and any characterizations are supported by documents obtained during the audit. These are the very documents (business plans, strategy, etc.) used to guide the company's operations and investment strategy.

It is noted that in two instances PTG's responses pointed out minor errors that resulted in corrections being made to the final report. On the whole, however, the audit team is confident in the results depicted in the audit report, and believes that PTG's responses are for the most part ill-focused, erroneous or greatly exaggerated.

Specific Replies

PTG's response (II.A.1,pages 2 through 3)
PTG asserts that NRF's price cap mechanism prevents Pacific Bell from shifting increased expenses to ratepayers; that the insignificant amounts spent for RD&D would not have resulted in any sharing with ratepayers anyway; ratepayers are not harmed by RD&D spending and ratepayers do not fund RD&D activities.

NARUC audit team's reply
R&D expenses are carried ATL till they are recategorized by the California Commission pursuant to a request by Pacific Bell. The NARUC team reported that inadequate tracking results in inaccurate expenditures being reported to the California Commission. The result is an overstatement of ATL RD&D expenditures and an understatement of BTL expenditures when a product or service is moved BTL. The former offsets revenue and decreases the amounts available for sharing with the general body of ratepayers under NRF. The latter results in competitive services not being charged the full amount of expenditures and cross-subsidization of those services by the general body of ratepayers. The amount of these RD&D expenditures may be quite significant once the true amounts are known. Since the true amounts are not known, one can not state with certainty that the RD&D expenditures are insignificant. RD&D expenditures do have an effect on ratepayers and the amounts available for sharing with them. PTG's contention is argumentative and is not supported by facts.

PTG's response (II.A.2, pages 3 through 4)
PTG asserts that the NARUC audit team ignores procedures adopted by the CPUC that protect ratepayers against errors in categorizing RD&D for new products; that Pacific Bell's reports on RD&D costs made pursuant to Decision (D.92-07-076) and existing California Commission procedures adequately protect ratepayers from cost shifting of RD&D expenditures from regulated to non-regulated services; that the use of tracking codes starting from the feasibility stage of a project is adequate; that the aggregation of projects for reporting of RD&D expenditures is not necessary and will not be required in the future by the recently issued RD&D decision (D.94-06-011). Furthermore, D.94-06-011 permits Pacific Bell to allocate RD&D costs ATL and BTL as it sees fit.

NARUC audit team's reply

The NARUC audit team pointed to numerous instances where the reporting of individual project expenditures that have accrued less than the $1 million threshold, on a cumulative basis, do not give a complete picture of expenditures related to a technology being researched by Pacific Bell. Furthermore, inadequate tracking and exclusions of activities from Pacific Bell's definition of RD&D understate the total expenditures on projects. The new procedures ordered in Decision D.94-06-011 were ordered because of inadequacies in Pacific Bell's implementation of prior California Commission decisions. The new decision has not been tested through detailed audits. Pacific Bell's dependence on that decision to somehow magically remove past errors in implementing and properly recording past RD&D expenditures is far fetched.

PTG's attempts at explaining away past errors because of new and as yet untested California Commission Decisions is argumentative and is not supported by facts.

PTG's response (II.B, pages 4 through 5)

PTG contends that the NARUC audit teams suggestion of prudency review prior to selecting an RD&D project would discourage innovation. In defense of that argument, PTG refers to a California Commission report and an excerpt from a 1989 Decision which does not require prudency reviews prior to making an investment by a telephone utility.

NARUC audit team's reply

The NARUC audit team is not aware of any decision by the California Commission that states that ratepayer interests should be subservient to those of utility shareholders. To determine if ratepayers have been disadvantaged, the benefits or harm of a decision from a ratepayer perspective must be determined and quantified. Furthermore, the concept of ratepayer indifference requires no cross-subsidization of utility non-regulated activities by ratepayer funded regulated activities. Pacific Bell is unable to accurately quantify expenditures on its various RD&D projects because of exclusions or, deficiencies in its accounting systems. It can not guarantee that ratepayers are not providing subsidies to its unregulated activities. It can not vouch that ratepayer indifference is maintained by its actions without a prudency review prior to selecting an RD&D projects.

PTG's assertion that it is complying with the spirit of California Commission decisions that require ratepayer indifference from RD&D investments is not convincing. Reviews must be performed to assure that ratepayer interests are not made subservient to those of stockholders and to prevent cross subsidization of non-regulated activities by regulated activities.

PTG's response (II.C, pages 5 through 6)
PTG asserts that its cost tracking and regulatory accounting treatment were appropriate. In defense of its position, PTG admits that there were minor errors in some of its accounts and that when errors were found, they were corrected. It also asserts that FCC audits did not find any major discrepancies. Furthermore, it maintains that proper tracking procedures were followed in most of the cases and that all RD&D and product specific expenditures can be tracked to an FCC account and by tracking codes. (Emphasis added).

NARUC audit team's response
PTG' positions are argumentative and lack substance. Records of expenditure that were maintained by almost all its new product development managers did not match those that were maintained in Pacific Bell's regulatory books of accounts. Importantly, Pacific Bell is unable to trace actual RD&D expenditures to line items reported to the California Commission. The NARUC audit team can not comment on the FCC audits because the scope of those audits are unknown. In any case, the FCC audit findings do not change the deficiencies noted by the auditors.

Major deficiencies have been reported in recording charges to proper tracking codes as well as to appropriate account codes by the auditors. **PTG's arguments do not obviate the need to strengthen Pacific Bell's accounting systems.**

PTG's response (II.D, pages 7 through 8)
PTG asserts that comprehensive affiliate transaction rules protect ratepayers. To back its contention, PTG refers to certain California Commission decisions which listed the rules to be followed by Pacific Bell in dealing with its affiliates. PTG claims that such rules ensure ratepayer indifference in affiliate transactions. To support its position, PTG refers to two audits that were conducted by the California Commission staff and the FCC and maintains that those audits did not find any major problems in compliance with those rules. The company is puzzled that the NARUC audit team did not cite specific examples of non-compliance with affiliate transaction rules.

NARUC audit team's reply
PTG mischaracterizes the findings of the California Commission staff. Both audits found areas of major concern in rules followed by Pacific Bell for affiliate transactions. At least two of the concerns regarding sharing of proprietary information with affiliates and the retention of audit trails

on projects continue to be violated. The NARUC audit team's report mentions specifically that for the PCS work at TTL, affiliate transaction rules were not followed. For example, no records of meetings involving Pacific Bell personnel were maintained and proprietary information and intellectual properties may have been shared without appropriate compensation to Pacific Bell. Furthermore, Pacific Bell's expertise was used to prepare the affiliate for participation in the PCS field.

PTG' contention that current California Commission rules are adequate to prevent cross-subsidization of non-regulated by regulated ratepayer funded operations is incorrect and is not supported by facts.

PTG's response (II.E, page 8)

PTG contends that a risk/benefit analysis cannot be done until feasibility of a product or service has been demonstrated. To back its contention, PTG cites that such analyses would be unnecessary under guidelines established under NRF and that such an analysis is possible only after a product or service is deemed to be profitable.

NARUC audit team's reply

Pacific could not identify all the RD&D projects that have been undertaken in its various departments, how many RD&D projects were started and abandoned or all expenditures that were associated with its RD&D efforts. This was because all RD&D expenditures were against departmental baseline budgets. Due to that reason, there is every reason to believe that total RD&D expenditures have been funded by ratepayers and that the contribution for sharing under NRF has been significantly diminished. RD&D is not done in a vacuum. The potential benefits to ratepayers are always possible to be determined prior to start of an effort. There is no excuse for not tracking charges against any RD&D activity.

PTG's assertion that a risk/benefit analysis from a ratepayers perspective can not be done prior to determining if a positive contribution will be made is not substantiated.

PTG's response (III.A, page 9)

PTG asserts that PCS was funded by its shareholders. Relatively smaller amounts were spent were spent by Pacific Bell, inclusions of those expenses had no effect on 1990-93 shareable earnings, and the amounts spent on a pre 1990 project at Belcore was all that was spent on PCS-R at Bellcore. That expenditure is being refunded to ratepayers via an advice letter filing at the California Commission on July 1, 1994.

NARUC audit team's reply

PTG' application with the FCC for PCS licenses are based on Pacific Bell's expertise that it gained through its association with wireless research at Bellcore and internally. Pacific's internal documents indicate research efforts in PCS(R) that were pursued internally at Pacific Bell. Such research efforts continued at Pacific Bell until the formation of TTL, when they were stopped. That effort was continued again after the spin-off of Air Touch was announced. The single pre-1990 project at Bellcore was not the only PCS related effort that was funded by Pacific Bell's ratepayers. Advice Letter filing (AL 17025) of July 1, 1994 is still being reviewed.

PTG' assertion that PCS was developed and funded by shareholders is inaccurate and is not based on facts.

PTG's response (III.B, page 9)

PTG asserts that work at TTL benefited both Pacific Bell and PacTel. PTG claims that Pacific Bell employees did not work outside California for State Tax reasons; a joint trial for PCS was held at San Diego; and all TTL results were shared between PacTel and Pacific Bell. These results have now been transferred to Pacific Bell's new PCS subsidiary, Pacific Bell Mobile Services (PBMS).

NARUC audit team's reply

TTL is a PTG subsidiary. However, based on interviews with Pacific Bell's experts, Pacific Bell rotatees to TTL had full access to Pacific Bell's subject matter experts to support them on various TTL working committees. Those experts have stated that the delineation between PCS (R) and PCS(W) was nebulous and that their time charges for TTL related work were not accurately segregated. Some of those charges were against departmental baseline budgets which were funded by the general body of ratepayers. TTL worked like a partnership between Pacific Bell and PacTel and was therefore referred to as a joint venture in the NARUC audit teams report.

Contrary to PTG's assertions, Pacific Bell's subject matter experts stated in interviews with the auditors that they worked on ALL aspects of PCS work at TTL irrespective of whether it involved inside or outside California licenses. For the San Diego trial, Pacific Bell contributed an AIN trial switch for which no charges were made to TTL. PCS was initiated and developed using Pacific Bell's ratepayer funded resources including the use of its experts who were loaned to help develop its affiliate, PacTel Corp. After PTG's wireless operations were spun off, a new Pacific Bell subsidiary (PBMS) was formed and all results from TTL were further transferred to PBMS. PBMS will offer PCS(R) and will be treated BTL with all benefits flowing to shareholders while utilizing Pacific Bell's PSTN and other resources. The final terms and conditions for the transfer have not been approved by the California Commission.

PTG's assertion that work at TTL benefited both Pacific Bell and PacTel is correct. What is not mentioned is that the beneficiaries are the shareholders of Pacific Bell. The extent of benefits to Pacific's ratepayers is questionable.

PTG's response (III.C, page 10)
PTG asserts that the PCS(R) business will be extremely risky and should be treated BTL. To insulate ratepayers from that extreme risk, PTG plans to transfer all Pacific Bell personnel who worked on PCS(R) to its new BTL subsidiary PBMS along with all information that was obtained by Pacific Bell through its association with TTL. PTG alleges that ratepayers did not fund PCS and that the audit team does not understand the risks associated with PCS(R).

NARUC audit team's reply
PTG plans to offer PCS(W) as an ATL service even though its own subject matter experts have indicated that PCS(W) is just as risky as PCS(R). Internal documents reviewed by the auditors indicate that the profitability of offering PCS(R) services, the projected demand for those services, and the possibility of retaining a substantial market share of the overall PCS market are extremely high for Pacific Bell. Furthermore, Pacific Bell needs to participate in the PCS(R) and PCS(W) markets to contain the erosion of its revenue base from potential bypass of its system. Pacific Bell's ratepayers funded the development of <u>ALL</u> PCS related work at Pacific Bell and at Bellcore. Now that the time has come for Pacific Bell's efforts to pay off, its experts have been transferred to a BTL subsidiary for the benefit of the stockholders. Under Pacific Bell's announced plans, PCS(W) and all its infrastructure investments and inherent risks will still remain with Pacific Bell's ratepayers, while the benefits from the highly lucrative PCS(R) will accrue to the stockholders.

PTG' contention that the lucrative PCS(R) will be extremely risky and should be BTL while the not so lucrative PCS(W) which is an equally risky venture should remain ATL is illogical.

PTG's response (III.D, pages 10 through 11)
PTG asserts that Pacific Bell will provide access to the telephone network for all carriers, PCS(W) is risky but not as risky as PCS(R), PCS work was not done to support PacTel's special needs, and that AIN will benefit cellular and PCS providers but, that this is just another benefit of AIN.

NARUC team's reply
Pacific Bell's PSTN has been developed using ratepayer funds. Access to the PSTN can not be denied to other carriers. The fact is that Pacific Bell's infrastructure was modified to be receptive to its affiliate's needs and to help its affiliate PacTel Corp. develop its PCS(R) expertise. According to Pacific Bell's subject matter experts, there was no evaluation of ratepayer benefits prior to modifying the PSTN to accommodate PCS(R). Furthermore, contrary to statements which indicate otherwise, documents reviewed by the NARUC audit team indicate that a justification for PCS(R) was that it would help "prove in" AIN. Also, PCS services offered without the benefit of the AIN benefits would be extremely limited. So, even though PCS does not require AIN, its competitive positioning would be seriously hampered without the benefits of AIN type of services.

PTG' contention that Pacific Bell will provide access to the PSTN to all other carriers does not detract from the fact that Pacific Bell might have been more than accommodative to help develop a market for its affiliates. It is now doing the same to accommodate its new affiliate, PTMS.

PTG's response (III.E and F, pages 11 through 15)
PTG asserts that Pacific Bell was not underpaid and did not contribute to PacTel's PCS expertise; Pacific Bell's proprietary information was not shared with affiliates; Bellcore proprietary information was not shared with TTL; Pacific Bell's billing to TTL was correct; Pacific Bell's business plans were not changed to accommodate PacTel; the spin-off has been beneficial to Pacific Bell's PCS plans; PCS(R) and PCS(W) should be categorized differently; Bellcore work on PCS was handled appropriately; AIN was not justified on the basis of PCS(R).

NARUC team's reply
PTG's assertions are argumentative and lack merit. The NARUC team's observations are based on documents that were provided to the auditors. See text of the NARUC audit team's report for details.

The NARUC audit team reported on PTG's decision making process at the time when decisions regarding the placement of PCS within PTG were being made. The auditors requested updates to the documents, plans and relevant material from PTG. None were furnished. The NARUC audit team's report is based on documents that were provided to it by PTG and its findings and conclusions are based on documentary evidence.

PTG's response (IV.A, page 15)
PTG asserts that BEST is not a family of projects and does not benefit competitive products; many R&D projects were not inter-related and so should not have aggregated expenditures; the currently used tracking procedures and analyses are adequate; and, under NRF, RD&D will not impact telephone rates.

NARUC audit team's reply
PTG's assertions are not supported by facts. Pacific's executives, in presentations to the California Commission staff have reported that the ATM network will be Pacific Bell's network of the future. That network will support predominantly competitive services.

The BEST project is an ATM based project. A number of projects have been discontinued or merged into that project. The concepts from those projects were carried into the project, those concepts were evaluated and may or may not have been pursued during various project phases but, the experience from each project was used. To the extent that each of the various technologies considered under Broadband Integrated Digital Network (BISDN), are compared to each other, all those projects are related and considered as part of the same family. Expenditures on those projects need to be aggregated to give the California Commission a fair idea of Pacific Bell's R&D in that area as indicated in the NARUC audit team's report.

PTG' response (IV.B.2 and B.4, pages 16-18)
PTG asserts that there are errors in descriptions and plans for Packet Video/Libernet, Video Communications Services (VCS) and SMDS projects.

NARUC audit team's reply
The statements contained in the report are based on documents provided to the auditors and statements made by Pacific Bell's subject matter experts. For example, Pacific Bell's subject matter experts indicated that Libernet would lend itself to be used over the ATM network. Similarly, the statements alluded to regarding plans for VCS and SMDS are based on documents provided to the auditors by Pacific Bell. To the extent that

Pacific Bell changed its final plans, it should have informed the auditors of those changes. PTG' contentions are not based on information provided to the auditors.

PTG' response (IV.C, items 1-4, pages 18 through 19)
PTG contends that the BEST project: will not lead to competitive products, is not related to any other projects, and project related expenditures have been appropriately tracked.

NARUC audit team's reply
BEST project researches the use of ATM technology in Pacific Bell's BISDN network. Pacific Bell's executives have informed the Commission staff that ATM will be the technology that will be used in Pacific Bell's future network. BISDN will be used to offer competitive services using ATM technology. Therefore BEST will lead to supply of competitive products and services by Pacific Bell. All projects mentioned in the audit report are related with the BEST project and may be considered as belonging to the same family. The audit report lists specific incidences where tracking was inadequate. Furthermore, specific accounting records could not be found for all R&D projects that were merged into project BEST.

PTG's response is not based on documentary evidence provided to the auditors, while the audit observations are.

PTG' response (IV.C, items 5-6, page 19)
PTG asserts that the main driver for network modernization is to improve operating efficiencies and cost effectiveness and the deployment of fiber is economically justified.

NARUC team's reply
PTG was unable to provide studies which quantified the financial impact of the operating efficiency improvements or justification studies performed prior to fiber deployment in Pacific Bell's network. The NARUC team's observations are still valid.

PTG' response (IV.C, items 7 through 9, page 19)
PTG asserts that it tracked all expenditures on various projects.

NARUC audit team's reply
PTG's assertions are contrary to the documentary evidence that was provided to the auditors. For example, the records maintained on all the projects by the respective project managers were different from the amounts that were maintained

for regulatory purposes. In case of INA and Multimedia Conferencing, PTG admits that the time charges were not segregated but maintains that this does not represent a problem in its tracking procedures.

The NARUC audit team's contention that tracking was inadequate on RD&D projects is based on documents provided by PTG and its observations are valid.

PTG' response (V.A, page 20)

PTG claims that it selected its Information Services Group (now PBIS) after considering other alternative vendors for providing voice mail for its CVM enhanced service. PTG also claims that all applicable trial guidelines for the number of payphones that could be retrofitted for purposes of the trial were followed.

NARUC audit team's reply

A review of project documents that were provided to the auditors indicated that a strategic benefit being considered for the project was to generate new revenue streams for ISG if that group was selected as the Enhanced Service Provider (ESP) for the service. As discussed in the audit report, ISG was selected as the ESP. Consideration of other vendors was not mentioned as stated in PTG's response.

A further detailed review of the documents provided by Pacific Bell indicates that the authorized number of payphones were used for the CVM trial. Appropriate corrections have been made to the NARUC audit team's report to reflect this fact.

PTG's response (V.B, pages 21-22)

PTG asserts that the VALUE 2000 project was not offered as a fully competitive service. It was a limited experiment which involved minor modifications to the PSTN and to help Pacific Bell identify future competitive and non-competitive services. It was not a vehicle to deploy any kind of service, including enhanced services or other competitive services. The project was discontinued but some of the concepts were carried on under two other projects to help develop similar services.

NARUC audit team's reply

The NARUC audit team's report states that the project was a research project. As stated in the report, the project involved modification to the PSTN to offer potentially competitive services. PTG's assertion that the project was not a vehicle to deploy any enhanced services is not backed by documentary evidence. For example, in the technical assessment of the project provided to the NARUC audit team, it is stated that the project would be used as a vehicle to

"..create opportunities and evaluate customer needs for new and enhanced Pacific Bell products and services". (PBL 014175).

PTG's response reinforces the NARUC audit team's finding that Pacific Bell's RD&D efforts are interrelated. When a project is discontinued, concepts and findings from such projects are continued under other projects. However, those expenditures are not continued in the surviving project. (See NARUC audit report item 26, page B-17). This also strengthens the auditors contention that all related RD&D projects should be mapped in reports submitted to the California Commission to give a proper perspective of the totality of the research involved. (See NARUC audit team report item 11, page B-11 and item 25, page B-17).

To accommodate PTG's response and to confirm that VALUE 2000 was not offered as a service, appropriate modifications to the NARUC audit team report have been made.

PTG's response (V.C, page 22)
PTG claims that Appendices C and D contain inaccurate statements; all broadband based activities are not competitive; and some of the new products identified in Table 2 should not be categorized because those products have not been offered.

NARUC audit team's reply
The NARUC audit team agrees that not all broadband based services are competitive. However, almost all applications that would be economically offered over that network would be competitive services. Table 2 gives the preliminary categorization of services based on documents that were provided by PTG to the auditors. PTG's objection is not based on documentary evidence.

PTG's Response (VI.A, page 22, VI.M, page 27):
PTG contends that PBD's contribution is irrelevant under NRF and ratepayers are protected by NRF from revenue losses.

NARUC Audit Team's Reply:
PTG's argument is incorrect. **Cross-subsidization goes against public policy no matter what the regulatory scheme is.**

PTG's Response (VI.B and C, page 23):
PTG argues that ratepayers did not fund PBD's R&D and claims that all expenses associated with electronic publishing had been tracked and total $1.5 million.

NARUC Audit Team's Reply:
The Audit Report demonstrates how PBD developed EYP using funds from ratepayers. The $1.5 million is inconsistent with the efforts PBD spent on EYP development as revealed in the Audit Report. The EYP Project Manager also admitted that there was no tracking of EYP development expenses until after meeting with the NARUC Audit Team in the last quarter of 1992. (NARUC Audit Report, Part C, Chapter 8, page 81)

PTG's Response (VI,D, page 23):
PTG alleges that the Audit Report mischaracterized Mr. Logan's and Mr. Gaulding's work.

NARUC Audit Team's Reply:
PTG's allegation is without support. **The Audit Report's reference to both Mr. Logan's and Mr. Gaulding's work is supported by their comments and documents.** (NARUC Audit Report, Part C, Chapter 5, page 33 - 39)

PTG's Response (VI.E, page 24):
PTG contends that the amount spent on electronic publishing was not substantial and that only $1.5 million was spent on developing EYP.

NARUC Audit Team's Reply:
The Audit Report indicates that a substantial amount of PBD staff resources was spent on EYP development. As explained in NARUC Audit Team's Reply to PTG's Response (VI.B) above, the $1.5 million is unreliable.

PTG's Response (VI.F, page 24):
PTG argues that only limited feasibility studies were conducted.

NARUC Audit Team's Reply:
PTG's argument is without support. The Audit found numerous studies PBD had conducted. For EYP development, PBD had conducted customer surveys, market research, feasibility studies and formulated product and business plans. (NARUC Audit Report, Part C, Chapter 5 and 6)

PTG's Response (VI.G, page 24):
PTG argues that electronic publishing involves high risk and should be treated BTL.

NARUC Audit Team's Reply:
Electronic publishing may involve high or low risk depending on the type of EYP product PBD chooses to provide and PBD's positioning in the electronic publishing market.

PTG's Response (VI.H, page 24, VI.K, page 26):
PTG contends that the Brooks-Dingell Bill prohibits use of any PBD synergies and that the Bill led to a further move in April 1994 of electronic publishing from Pacific Bell Information Services to Pacific Telesis Electronic Publishing Services.

NARUC Audit Team's Reply:
The final outcome of the Communication Act of 1994 is uncertain at this time and therefore **it is premature to assume that PBD would be prohibited completely from entering the EYP market.**

PTG's Response (VI.I, page 25):
PTG alleges that electronic publishing is not a major threat to PBD.

NARUC Audit Team's Reply:
PTG admits that the future impact of alternative advertising media is unknown. What is known is PBD's intention of developing EYP originated from Mr. Gaulding's concern that: the printed yellow pages were experiencing collapsing margins and business growth had become difficult; "for PBD to maintain its market leadership position, PBD not only must improve its cost efficiency, but also must explore new opportunities in marketing and electronic information services in order to diversify single product focus." (NARUC Audit Report, Part C, Chapter 5, page 33)

PTG's Response (VI.J, page 26, VI.R, page 29):
PTG contends that it followed applicable rules when electronic publishing was moved and that current rules protect ratepayers.

NARUC Audit Team's Reply:
The audit found that the current affiliate transaction rules may be inadequate to prevent such cross-subsidization.

PTG's Response (VI.K, page 26): - see NARUC Audit Team reply to VI>H.

PTG's Response (VI.L, page 26):
PTG alleges that electronic publishing lacks synergies with PBD.